

*Admitted
4/22/05*

REBUTTAL TESTIMONY

of

Steven R. Knepler

Accounting Department

Financial Analysis Division

Illinois Commerce Commission

**Reconciliation of revenues collected under gas adjustment
charges with actual costs prudently incurred.**

North Shore Gas Company

Docket No. 01-0706

February 18, 2005

OFFICIAL FILE
I.C.C. DOCKET NO. 01-0706
STAFF EXHIBIT NO. 9.00
Witness Knepler
Date 4/22/05 Retainer TR

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1 **WITNESS IDENTIFICATION**

2 Q. Please state your name and business address.

3 A. My name is Steven R. Knepler. My business address is 527 East Capitol
4 Avenue, Springfield, Illinois 62701.

5 Q. Have you previously filed testimony in this proceeding?

6 A. Yes. My Direct Testimony was filed in August 2003 as ICC Staff Exhibit 1.00 and
7 my Additional Direct / Rebuttal Testimony was filed in January 2005 as ICC Staff
8 Exhibit 5.00.

9 Q. What is the purpose of your rebuttal testimony?

10 A. The purpose of my rebuttal testimony is to respond to comments made by
11 Company witness Zack regarding Staff's recommendations for (1) a
12 management audit of North Shore's gas purchasing practices, gas storage
13 operations and storage activities and (2) annual internal audits of its gas
14 purchasing practices.

15 **AUDIT RECOMMENDATIONS**

16 Q. North Shore witness Zack states that "Imposing both an external audit
17 requirement and an ongoing internal audit requirement is unnecessarily

18 burdensome" (Respondent Ex. G, p. 3, lines 38-39). Do you care to comment on
19 Mr. Zack's statements?

20 A. Yes. I continue to believe that both the (external) management audit¹ of North
21 Shore's gas purchasing practices, gas storage operations and storage activities
22 and the annual internal audits² of its gas purchasing practices are warranted.
23 The external management audit is intended to be a forward looking evaluation of
24 the internal control requirements that need to be implemented to ensure that
25 ratepayers are protected when purchasing and storage decisions are made. The
26 purchasing and storage decisions evaluated during the management audit
27 include, but are not limited to, the awarding of gas supply contracts, the
28 allocation of company owned storage, the decision to lease storage capacity, and
29 storage injection and withdrawal activities. The annual internal audit is a
30 historical evaluation of transactions and their compliance with the internal
31 controls established by the management audit. With respect to Staff
32 recommendations the annual internal audits are a necessary follow-up to the
33 management audit.

34 During the review of the 2001 reconciliation, Staff has discovered what it believes
35 are serious breakdowns in internal control. These internal control breakdowns,
36 which are supported in part by the internal audit of enovate operations,³ include
37 undocumented transactions, oral agreements, and revenue sharing. Therefore, it

¹ Recommendation at ICC Staff Exhibit 5.00, p. 9, lines 164-178.

² Recommendation at ICC Staff Exhibit 5.00, p. 9, lines 159-163.

³ Docket No. 01-0707: ICC Staff Exhibit 9.00 (Hathhorn Additional Direct / Rebuttal Testimony), Attachment E.

38 is a logical, two-step approach, first, to establish a series of internal control
39 procedures (management audit) and, second, to evaluate on an annual basis the
40 Company's decisions and transactions on how well it complied with the
41 guidelines establish by the management audit.

42 Q. Company witness Zack states, on page 3 of his additional rebuttal testimony, that
43 the Company proposes that it provide Staff information about its current gas
44 supply and capacity procurement process and, if Staff wishes to initiate a
45 proceeding at that point, it can make the appropriate recommendations to the
46 Commission. Please comment.

47 A. The purpose of this proceeding is to reconcile prudent costs and revenues for a
48 past historical period. It is not appropriate for the Commission to evaluate the
49 Company's current internal controls within this reconciliation. It is appropriate for
50 this Commission to recommend to the Company to take action to evaluate
51 current practices in light of the findings regarding the Company policies in 2001-
52 2002 to safeguard ratepayer interest.

53 Q. North Shore witness Zack states that Staff's internal audit proposal is not
54 unreasonable, but the Company is opposed to the recommendation absent a
55 deadline provision. Please comment.

56 A. Staff's management audit and internal audits proposals are to be considered in
57 tandem. The management audit establishes internal control procedures (i.e.,

58 "what the Company should do") and the internal audits determine how effective
59 the Company was in implementing the internal controls (i.e., "how it has done").
60 North Shore must demonstrate, over a period of time, to the Commission, its
61 board of directors and stockholders that the internal audits are unnecessary.
62 North Shore's future performance will determine the time-period of the internal
63 audit requirement. Again, Staff continues to support its recommendations for a
64 management audit and an internal audit.

65 **SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS**

66 Q. In the companion reconciliation for Peoples Gas, Docket No. 01-0707, you made
67 a recommendation to reopen the 2000 PGA reconciliation (Docket No. 00-0720).
68 Does that recommendation also apply to the North Shore Gas Company's 2000
69 PGA reconciliation (Docket No. 00-0719)?

70 A. Yes. Since the companies are affiliates and share purchasing and storage
71 functions, it would be appropriate to reopen North Shore's 2000 PGA
72 reconciliation.

73 Q. Please summarize the current status of your recommendations.

A. I am proposing 5 recommendations in this proceeding, the Company has agreed to update its operating agreement (Recommendation 2).⁴ The remaining four recommendations are disputed. My five recommendations are the following:

Recommendation 1:

I recommend that the Commission adopt Staff's proposed PGA reconciliation as reflected on ICC Staff Exhibit 5.00, Schedule 5.01. Staff's reconciliation shows that \$3,962,969 is to be refunded to North Shore Gas' PGA customers via the Commodity Gas Charge (CGC) through an Ordered Reconciliation Factor (Factor O) to be reflected in the Company's first monthly PGA filing submitted after the date a final order is entered in this proceeding;

Recommendation 2:

I recommend that North Shore Gas immediately update its operating agreement approved by the Commission in Docket No. 55071;

Recommendation 3:

I recommend that North Shore Gas perform an annual internal audit of its gas purchasing practices and submit a copy of the report to the Manager of the Commission's Accounting Department by May 1 of the year following the audit until the Commission finds that an internal audit is no longer necessary upon a formal request by the Company;

Recommendation 4:

I share Staff witnesses Anderson and Rearden's recommendation that North Shore Gas should engage outside consultants to perform a management audit of its gas purchasing practices, gas storage operations and storage activities. The firm selected to perform the management audit is to be independent of the Company, Staff and Interveners to Docket Nos. 01-0706 and 01-0707. The independent directors of Peoples Energy Corporation's audit committee should manage the management audit. Monthly reporting of the progress of the conduct of the management audit should be submitted to the Bureau Chief of the Commission's Public Utilities Bureau, with a copy to the Manager of the Commission's Accounting Department, until the management audit report has been formally submitted. Upon completion, which shall occur no later than 12 months after the date a final order is entered in this proceeding, copies of the management audit report are to be submitted to the Public Utilities Bureau Chief and the Manager of the Accounting Department.

⁴ Respondent's Ex. G, p. 2, Lines 29-31.

109 Recommendation 5:
110 I recommend that the Commission reopen Docket No. 00-0719, North Shore
111 Gas' 2000 PGA reconciliation.

112 **CONCLUSION**

113 Q. Does this question end your rebuttal testimony?

114 A. Yes.